IN THE HIGH COURT OF JUDICATURE AT BOMBAY
ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX REFERENCE NO. 412 OF 1988.

M/s Bipinkumar & Brothers ... Applicant.

V/s.

The Commissioner of Income- tax,
Bombay City V, Bombay. ... Respondent.

Ms. Aasifa Khan for the applicant.

Shri A.N. Kotangale with D.A. Dubey i/b K.C. Sidhwa for the respondent.

CORAM : V.C.DAGA AND A.S.AGUIAR, JJ.

DATED : 19.8.2005

P.C. :

. By this reference under section 256 (1) of the Income-tax Act, 1961 (the 'Act' for short), the Income Tax Appellate Tribunal (the Tribunal) has referred the following questions of law for the opinion of this Court:

1. Whether, on the facts and in the circumstances of the case, the payment of 15% of the net profits of the firm, for a period of 10 years from 1.7.1979 to the retired partner, Deepak K. Doshi, on account of clause 6 in the Indenture of Retirement dated 6.10.1979 in consideration of his relinquishing his entire interest in the firm, is allowable as a revenue expenditure.

2. Whether the payment made to Deepak K. Doshi in the circumstances mentioned in Question No. (i) were diversion of income by overriding title.

FACTS:

2. The assessee was a registered firm consisting of four partners . One minor by name Deepak K. Doshi had been admitted to the benefits of the firm under a deed of partnership dated 25.7.1974. When Deepak K. Doshi attained majority, he elected to become a full-fledged partner of the firm under the deed of partnership dated 15.4.1977.

3. Shri Deepak K. Doshi, after sometime wanted to enrol himself as an Article Clerk to qualify for the course of Chartered Accountant. He, thus, found it difficult to continue as a partner of the firm. He, therefore, sought retirement from the firm with effect from 1.7.1979. He retired under the Deed of Retirement dated 6.10.1979 . Under the said Deed of Retirement the firm agreed to pay 15 percent of its net profits to Deepal K. Doshi for a period of 10 years w.e.f. 1.7.1979 towards the consideration for having allowed the firm to use his interest in the stock-in-trade and goodwill of the firm. A charge was created on the asset of the firm to ensure regular payment of the said amount to Deepak K.Doshi. The partnership firm came to be constituted under the Deed of Partnership dated

6.10.1979 wherein specific term with regard to payment of 15% profit came to be incorporated. Accordingly, the firm paid Rs. 11,164/- and Rs. 27592/- to Deepak K.Doshi during the accounting year relevant to the assessment year 1980-81 and 1981-82 respectively.

4. In the assessment under consideration, these amounts were claimed as business expenditure by the assessee firm, contending that it is a revenue expenditure or in alternative, it is a diversion of income by an overriding title in favour of Deepak K.Doshi. The I.T.O. held that the payment to Deepak K. Doshi was not for the purposes of business as such it was capital expenditure. The I.T.O. thus added these amounts to the total income of the firm.

5. In the appeal, the C.I.T. (Appeals) for both the years, upheld the additions. The Tribunal affirmed these additions and dismissed the second appeals filed by the assessee. The rectification application being M.A. No.37/Bom/1986 filed by the assessee also came to be dismissed by the Tribunal by order dated 31.1.1987, holding that there was no apparent mistakes in the Tribunal's order warranting

any rectification. At the instance of the assessee, the questions of law, mentioned in the opening part of this judgment; are referred for the opinion of this Court.

Consideration:

6. Before dealing with the questions set out hereinabove, it would be relevant to quote the relevant clauses of the Deed of Partnership dated 6.10.1979 around which controversy revolves.

> **Clause 6:** The net profits of the partnership business after defraying all expenses such as salaries, rent, etc. and payment to be made to Shri Deepakkumar Kantilal Doshi, viz.,15% of the net profits as agreed to in the deed of retirement dated 6.10.1979 and other incidental expenses, shall be derived between the partners in equal parts and the partners have also agreed to bear the losses, if any, accordingly in equal part.

7. As already indicated hereinabove, aforesaid clause is integral part of the Deed of Partnership dated 6.10.1979 which provides for the mechanism as to how net profits of the partnership is to be calculated or drawn and in what ratio it should be paid. This clause also provides that in the event of loss the same is to be shared by remaining two partners i.e. Sudhir Kantilal Doshi and Jayesh

Kantilal Doshi in the ratio 50:50.

8. Readig of the aforesaid clause in its proper perspective goes to show that the net profit of the business is required to be calculated after defraying all expenses such as salaries, rent etc. that too after subtracting payment to be made to Shri Deepakkumar Kantilal Doshi @ 15% of the net profit as agreed in the deed of retirement dated 6.10.1979 along with other incidental expenses. Thus, payment of 15% of net profits to Deepakkumar Doshi are put in the category of expenses.

9. On the above backdrop, whether the amount paid to Deepak K. Doshi @ 15% of net profit is a revenue expenditure or a diversion of income by overriding title is a vexed question in the Income-tax law. There is a plethora of case law dealing with this question. The principles to be deduced from the various decisions may appear to be simple, but its application to the facts of a particular case is often difficult. It is not necessary for us to deal with the entire case law on this question. We may only refer to the relevant basic decisions, which to our mind are little close to the facts of the present case.

10. In **Raja Bejoy Singh Dudhuria vs. C.I.T. 1 ITR 135,** the Privy Council held that where an amount had to be paid to the step-mother in pursuance of a decree creating a charge on the assessee's resources; it was not application of the assessee's income but rather the allocation of a sum out of his revenue before it becomes income. A diversion of income by an overriding title need not necessarily be by a decree of court or by statutory or customary law, but may be under the provisions of a will, or agreement, or deed of sale or gift or partnership or sub-partnership or partition of joint family property.

11. In the case of **C.I.T. Kerala vs. Travancore sugar and Chemicals Ltd.(1973)88 ITR 1 (SC)**, a company was formed to take over the assets of a manufacturing concern from the Government and that the Government was entitled to receive 20% of the net profits earned by the company in every year subject to a maximum of Rs. 40,000/- per annum after providing for depreciation and remuneration of the secretaries and treasurers. It was held by the High Court that the amount constituted capital

expenditure. On appeal, the Supreme Court held that the payment was in the nature of revenue expenditure but remanded the case to the High Court for determining the questions: (1) Whether the payment was tantamount to diversion of profits by a paramount title; (2) whether the transaction was a joint venture with an agreement to share profits, and (3) whether the requirements of section 10(2)(xv) were satisfied. The department after remand did not press before High Court one of their the contentions that the transaction was a joint venture with an agreement to share profits. The High Court, by a majority, held that the amount could be said to be diverted by paramount title as such the amount was an allowable deduction under sec. 10(2)_(xv).

12. On appeal, the Supreme Court, held that the amount was deductible from the income of the assessee as an overriding charge and also as a revenue expenditure. While taking this view, the Apex Court observed as under:

> " It appears to us that the amount to be paid by reference to profits can either be that it is paid after the profits become divisible or distributable or that the amount is payable prior to such distribution or division to be computed by a reference to

> notional as in some decisions what is termed as apparent net profits. In the former instance it will certainly be a distribution of profits and not as deductible as an expenditure incurred in running the business but in the latter, it may, on the facts and circumstances of the case, and the agreement or the nature of the obligation under the particular instrument, which governs the obligation, be an expenditure incurred as contribution to the profit-earning apparatus or, as it is said, incurred at the inception and deductible as an overriding charge of the profit-making apparatus or is one laid out and expended wholly and exclusively for purposes of such business. It is true that sub-section (1) of section 10 of the Indian Income-tax Act, 1922, imposes a charge on the profits and gains of a business which accrue to the assessee while sub-section(2) of the said section enumerates various items which are admissible as deduction. Where income which accrues to the assessee is not his income, the question of admissible deduction would not arise. Therefore, where income is diverted at source so that when it accrue it is really not his income but is somebody else's income the question as to whether that income falls under sub-section (2) of section 10 does not arise. Again, income can be said to be diverted only when it is diverted at source so that when it accrues it is really not the income of the assessee but is somebody else's income."

13. Let us apply the above test to the facts of this case in the light of Clause 6 of the partnership deed. Clause 6 provides that 15% of the net income shall be deductible from net profit and this deduction is placed in the company of other expenses such as salary, rent etc., which are required to be incurred in running business. Seen from this angle, the amount was deductible from

income of the assessee as an overriding charge. Following another line of thinking even if it is assumed that it is a diversion of income by overriding title, even then, it will not form part of income of the assessee. Thus, viewed from any angle, assessee will be entitled to deduction.

14. In our view, no specific finding on any of the questions is necessary in view of our coclusion that the amount shall be deductible from the income of the assessee as an overriding charge and also as a revenue expenditure. Reference accordingly shall stand disposed of with no order as to costs.

(A.S.AGUIAR, J.) **(V.C.DAGA, J.)**